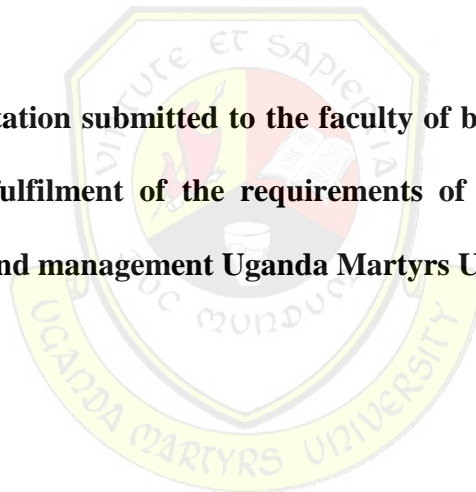


**INTEREST RATES AND THE PERFORMANCE OF COMMERCIAL BANKS IN  
UGANDA  
A CASE STUDY OF CENTENARY BANK**

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**An undergraduate dissertation submitted to the faculty of business administration and management in partial fulfilment of the requirements of the award of a degree in business administration and management Uganda Martyrs University**



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## **Dedication**

This academic work is dedicated to my parents Mr and Mrs **Kizito Rogers** for all the time, money and effort they put into my studies. Without their support, this course may never have been a reality for me. So thank you very much dad and mum

## **Acknowledgement**

Research is a very tiring process and time consuming too and to come this far is an achievement, not only for me, but for all those who were involved in the entire process.

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**List of abbreviations.**

BBC: British Broad Casting Corporation

CBR: Central Bank Rate

CEBR: Center for Economics and Business Research limited

GDP: Gross Domestic Profit

HIS: High Intensity Signal

ITL Inflation Targeting Lite

KCB: Kenya Commercial Bank

NPLs Non-Performing Loans and other Assets

SHS. Shillings

UK: United Kingdom

Min: Minimum

Max: Maximum

Std.dev: Standard Deviation

SPSS: Statistical Package for Social Scientists

ROA: Return on Assets

## **ABSTRACT**

The study evaluates the effect of interest rates on the performance of commercial banks in Uganda and was carried out in Centenary bank at the headquarters. It was based on the following research questions; how do real interest rates influence the performance of commercial banks and to what extent does the level of nominal interest rates affect the performance of commercial banks. The study sought to determine the effect of interest rates on the performance of commercial banks in Uganda.

The research adopted was a case study design that included a time dimension that was cross sectional backed on largely qualitative and some quantitative views. Data was collected from 45 respondents from Centenary bank headquarters which was analysed using SPSS (Statistical Package for Social Scientists).

The study found that there is a relationship between real interest rates and performances of commercial banks. The study also found that nominal interest rates affect performance assets in banks as it increases the cost of loans charged on the borrowers. The study recommends there is need for government to regulate interest rates as this would help to safeguard borrowers from exploitation by commercial banks.

In conclusion real interest rates and nominal interest rates affect the performance of commercial banks in Uganda as there is a relationship between the two.



## **CHAPTER ONE**

### **INTRODUCTION**

#### **INTRODUCTION**

Mugume, bank of Uganda executive director (2011) says the interest rate channel is the primary mechanism in conventional macro-economic models. The basic idea is straightforward given some degree of price stickiness, an increase in nominal interest rates example translates in to an increase in the real rate of interest and the user cost of capital. The effectiveness of monetary policy will depend not only on its ability to affect real interest rates, but also on the sensitivity of consumption and investment.

Financial performance analysis is the process of identifying the financial strength and weakness of the firm by properly establishing the relationship between the items of balance sheet and profit and loss account. Quarden (2004) argued financial performance analysis helps in short term and long term forecasting and growth can be identified with the help of financial performance analysis. Financial performance is an indicator of how profitable a company is relative to its total assets. It is measured by return on assets. ROA provides an idea as to how effective management is at using its assets to generating earnings. Interest rates affect financial performance directly and indirectly, when interest rate is high borrowers are discouraged to borrow Were and wambua (2013).

#### **BACKGROUND TO THE STUDY**

Interest rates are the percentages of the sum of money charged for its use. It can also be the yearly price charged by a lender to a borrower in order for the borrower to obtain a loan. Commercial banks offer different loans and interest rates and some are real rate, nominal, fixed, prime, and non-fluctuating, discount rate, commercial paper rate, corporate bond rate, and floating, introductory rate, and others. The benchmark interest rate in Uganda was last

recorded at 11 percent. Interest rate in Uganda averaged 14.43 percent from 2011 until 2014, reaching 23 percent in November of 2011 and a record low of 11 percent in June of 2013.

Banking performance is instrumental in development of the economy (Barajas, et al., 2000; Chirwa, 2001). Inefficiency in the financial system in most developing countries has persisted even though most countries have undertaken financial liberalization over the past two decades. Honohan and Beck (2007) observe that in many countries the range of financial products remain extremely limited, interest rate spreads are wide, capital adequacy ratios are often insufficient, loan recovery is a problem and the share of non-performing loans is large. The expectation is that the removal of government controls on interest rates and of barriers to entry into the financial system would lead to greater competition and improve performance of financial institutions.

Macro-economic instability and the policy environment also affect the pricing behaviors of the commercial banks and therefore their performance. In order to capture the effects of the macroeconomic and policy environment, the bank performance equations include inflation, growth of output and money market real interest rates as control variables. Claessen, et al. (2001), Dermirguc-Kunt and Huizinga (1999) noted that banking industry performance and inflation are negatively associated.

Interest has an indirect impact on financial performance through impacting the economy. High interest rates to borrowers discourage borrowing, this results in a shrunken investment through the multiplier effect. Savings are reduced and these have a negative impact on bank performance (Ngugi, 2004).

According to Sanya (2014) firms are starting to borrow cheaply from abroad to sidestep high lending rates in Ugandan markets. Commercial banks' lending rates in Uganda are the

highest in East Africa leading to lower than projected credit growth and climbing non-performing loan rates according to a new vision survey. The average shilling commercial bank lending rate in Uganda hit 23percent in July, from 22 percent and to a certain extent; stringencies in the financial institutions act are to blame. Only 20 percent of the entire Ugandan population has interfaced with a bank and alternative saving mechanism hold relatively small shilling amounts per house hold effectively handing bankers the ability to keep lending rate high.

Mugume (2014), noted at the end of July that certain large firms are borrowing in dollars and from abroad to finance local expansion to avoid the high banking rates. Uganda's central bank kept its main lending rate at 11 percent saying inflation was within its target and the economy was on track to grow 6 percent this fiscal year 2014. The bank of Uganda cut its benchmark rate to 11percent in June 2013 as governor Emmanuel Tumusime Mutebile voiced concerns that downside risks from the global and domestic economy growth of around 7percent achieved in previous years. (Tumusime, 2014)

According to Craigwell and Maxwell (2006), the tradition role of commercial banks centers on intermediate and generation of net interest income through two core activities: that is, the gathering of deposits on which banks pay interest and issuing of loans for which they receive interest income. Over the years, however commercial banks (United States and other developed countries) have gradually expanded beyond their traditional role and sources of income to encompass more activities that generate non-interest income. Deyoung and Roland (2001) argues that stabilizing interest rate increase the volatility of bank earning.

According to annual reports of centenary bank 2011, 2012, 2009, 2007, the performance of the commercial bank was as follows in relation to interest rates; firstly net interest income which is the margin between interest income and interest expenses, remain the main source of

income for the bank. Net interest for the year 2012 was shs.155.9 billion, 2011 it was shs.124.8 billion, 2010 it was shs.91.1 billion, 2009 it was shs.82.7 billion, in 2007 it was 53,326,005. This shows that as the years go by, the interest income increases and this shows the performance of commercial banks particular centenary bank.

According to Schwinger (n.d) assessed lending behavior of banks, financial structure and savings; availability, terms and charges for loans and other services and charges in financial structure and established a number of questions concerning the performance of financial institutions have not been previously explored in a broad systematic structure to attract savings and to utilize them efficiently, loan policies and charges, the range of financial services provided the economics of size and form of financial institutions. These questions are a major importance for the community and regions to be served.

By the end of the year 2000, commercial bank credit to the private sector was only six percent of GDP and banks only lent out 54 percent of their deposit base to the private sector. By the end of 2012, 80 percent of the banks' deposit base had been lent out to the private sector and private sector credit as a share of GDP had risen to 15 percent. Kasekende (2013).

## **PROBLEM STATEMENT**

Sanya (2014) argued in the New Vision on Friday 21 2014 that interest rates of commercial banks have an effect on the performance of banks, when they are high they affect the number of customers, loans given out and turn over. He also states that in spite the indication that the economy is stabilizing, many Ugandans are still paying expensively for the loans they get from the bank, fewer people were borrowing after the central bank increased its bench mark central bank rate to 23 percent at its highest in December to January, forcing commercial banks to raise their borrowing rates to 29.5 percent turning away many potential borrowers.

Boldbaatar (2006) argued interest rate spread remain a controversial area while some link it to market or individual banks inefficiency. Ng'etich (2011) argued banks perform well when managers to keep interest spread wide. The argument in most studies says large banks are more efficient than smaller and growing banks by Boldbaatar (2006).

According to (Sanya, 2013), Speaking at the customer's day, 29th September, clients complained that high prime interest rates were eating in to their business. The banks interest rate is at 21 percent, which can be increased or decreased by a certain factor depending on the borrowers risk profile. Even when the central bank rate which is now 12 percent came down, customers fumed that the bank did not reduce lending rates to a convincing rate. Last year when economic conditions were considered hard, the bank made monstrous profit of shillings 54.6 billion with its assets hitting shillings 1 trillion making their performance great. Customers said they could have shared on the profits by having lower interest rates.

## **OBJECTIVES OF THE STUDY**

### **BROAD OBJECTIVE**

It sets to determine the relationship between interest rates and the performance of commercial banks

### **SPECIFIC OBJECTIVES**

- I. To determine the effect of real interest rates on the performance by centenary bank Uganda
- II. To find out the effect of nominal interest rate levels on the performance of centenary bank Uganda.

## **RESEARCH QUESTIONS**

- I. How do real interest rates influence the performance of commercial banks?

II. To what extent does the level of nominal interest rates affect the performance of commercial banks?

### **Research Hypothesis**

There is a relationship between interest rates and the performance of commercial banks

Real rate of interest affects the performance of centenary bank both positively and negatively

Nominal interest rates have an effect on the performance of centenary bank.

### **SCOPE OF THE STUDY**

**1.3.1 Content scope;** the researcher intends to study the effect of interest rates on the performance of commercial banks.

**1.3.2 Geographical scope;** the study is conducted at Centenary bank's head offices located on plot 44-46 Kampala Road, Mapeera house.

**1.3.3 Time scope;** the research is to take a period of two years that's 2014 and 2015. This is the time allocated for the study.

### **SIGNIFICANCE OF THE STUDY**

The study is intended to be a basis for further research

The study is intended to help the researcher get to discover answers to the questions through the application of scientific procedures, and to gain familiarity about interest rates and the performance of commercial banks.

The study is also intended to add on the existing knowledge and literature about the study relating to interest rates and the performance of commercial banks.

### **JUSTIFICATION**

The study is intended to teach or help the case study centenary bank: head office to know how interest rates affect their performance. If the research is not carried out immediately, the

employees especially the top management may never know how influential interest rates can be on their performance. And hence they may never develop new ways of strategies of dealing with the ever changing interest rates.

### **DEFINITION OF CONCEPTS /KEY TERMS:**

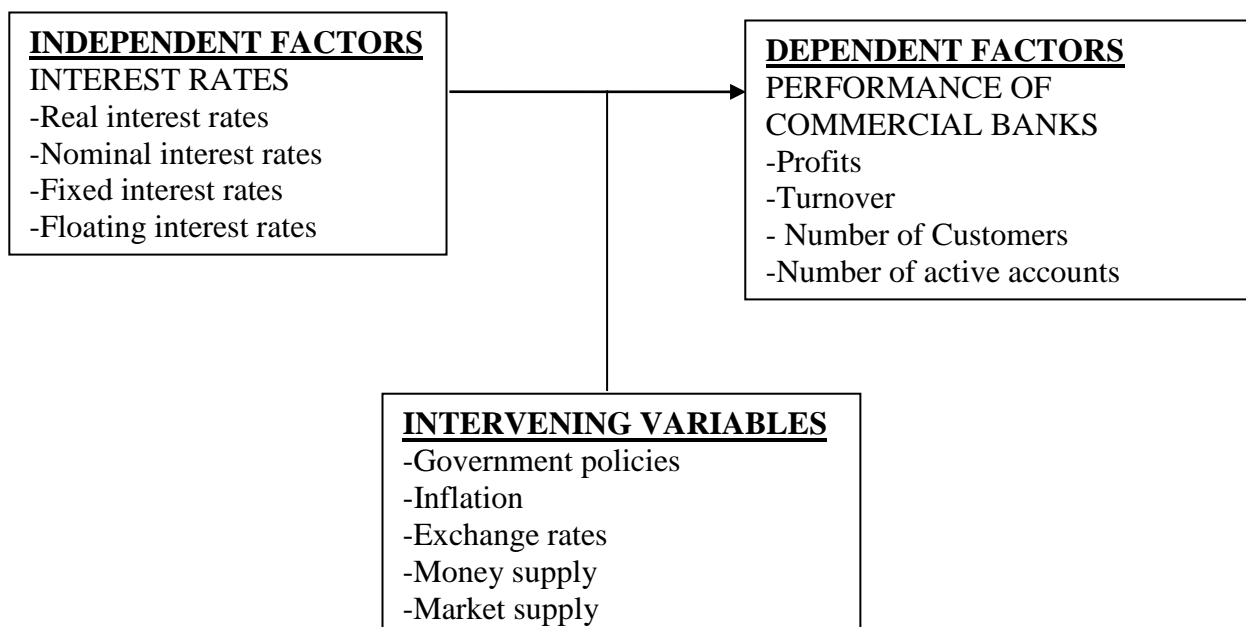
**Interest rates;** interest rates are payments from borrowers to lenders which compensate them (lenders) for parting with funds for a period of time, and some risk. It can also be defined as the cost of borrowing.

**Performance;** the way you do something; especially how successful you are.

**Commercial banks;** these are institutions which collect funds from the public and place them in financial assets such as deposits, loans and bonds rather tangible property.

### **CONCEPTUAL FRAMEWORK**

The research will constitute of three variables of which two are major. The independent variable is interest rates and the dependent is performance of commercial banks. It is assumed that interest rates have an impact on the performance of commercial banks.



Source adopted from the works of Woodford (2003) and modified by the researcher.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **LITERATURE REVIEW**

This is mainly the second part of a research project. The literature relates to the study that is based on knowledge acquired or accumulated from different authors about interest rates and



the performance of commercial banks. The areas to cover include; the major interest rates measures, real interest rates and nominal interest rates.

## **INTEREST RATES**

An interest rate is the interest per year as a percentage of the amount loaned (McEachern, 1997). According to him, the greater the interest, keeping other factors constant, the greater the reward for lending money. Interests are of two types nominal and real. Nominal interest rates are paid in actual money form. They are the interest rates that we use in everyday discussions and which we see quoted in advertisements, in the media and in official announcements. On the other hand, real interest rates are returns that lenders require even if there is no risk and prices are constant. They can also be defined as the rate of interest that lenders would need to compensate them for postponing consumption until some point in the future, given constant prices.

Van Horne (1998) suggests there are three ways interest rates can be paid. The first is that on collect basis where the interest is paid at the maturity of the note and is deducted from the initial loan. Secondly, on discount basis and lastly, on add-no basis.

Mugume (Executive director, Bank of Uganda) (2011) says Interest rate channel is said to be the primary mechanism in conventional macroeconomic models. The basic idea is straightforward given some degree of price stickiness, an increase in nominal interest rates example translates in to an increase in the real rate of interest and the user cost of capital. These channels in turn lead to a post ponement in consumption. The effectiveness of monetary policy will depend not only on its ability to affect real interest rate, but also on the sensitivity of consumption and investment.

Inflation is one of the factors that affects interest rates as the rates paid on most loans are fixed in the loan contract.

A lender could be so reluctant to lend money to a borrower for any period of time if the purchasing power of that money will be less at the time of repaying it back, the lender will, therefore, demand a higher rate and this is well known as an “inflationary premium”. Thus inflation pushes interest rates higher, deflation causes rates to decline. Over time, as the cost of products and amenities rise, the value of money decreases. clients will therefore have to spend more money for the same products or services which had cost less in the previous year. Achin (2011)

Winston and Rowland (2002) noted that high interest rate can have a major implication for financial intermediation as they can increase the cost of capital which in turn limits financial resources available to potential borrowers thereby reducing the volume of investment opportunities and reducing it to sub optimal level. Moreover wider spread might reflect a number of problems such as bank unsoundness and moral hazard.

Uganda’s central bank raised rates in 2012 when inflation hit more than 20 percent. Shop keepers in Kampala say interest rates of up to 27 percent are crippling their business a BBC correspondent says most works are closed, leaving clients who travel to Kampala from across east Africa unable to stock up. Anon (2012). Busingye (2014) also argued that ever since Bank of Uganda introduced the Central Bank Rate under its Inflation Targeting Lite (ITL) regime in July 2011, the interest rates administration in commercial banks would drive even the most tranquil lenders crazy. The new monetary policy tool debuted in July 2011 with the sole aim of “fighting inflation,” which previously was amplification by “mopping up excess liquidity.” The Central Bank, every month, sets the CBR aimed at guiding short-term interest

rates to influence other interest rates in the economy such as lending and deposit rates offered by commercial banks. The CBR, which debuted at 11%, jumped to a high of 23% - and influenced the upward movement of commercial bank lending rates, which almost touched a record 30% mark. This sent shock waves in the banking industry as non-performing loans assets hit the roof and borrowers were sent scampering out of the banks.

In her works, Swanson (2014), says why China's interest rate cut will not spur economic growth is that china's central bank focuses on appearance, not substance. The Chinese central bank's interest rate cut is largely a symbolic move which limited practical effect. China's central bank carried out one of its famous surprise moves after the markets closed, the central bank announced it was cutting interest rates, the first time it has done so in more than two years. In a move widely viewed as a recognised of the need to return to a more expansionary monetary policy to stimulate growth, the Chinese central bank or people's bank of china cut the bench mark lending rate by 0.4 percent to 5.6 percent from 6 percent.

Corfe (2014), head of macroeconomics at the CEBR, said, "what looked like a February 2015 rate rise a few months back is increasingly looking like a November 2015 rate rise. The unusually uncertain economic environment at present means that a rate rise is likely to come later rather than sooner"

According to the annual supervision report (2011) the bank of Uganda changed the conduct of fiscal policy so as to use a short term interest rate in order to attain the target of low and unchanging inflation. The functioning target, which is the Central Bank Rate would serve as of bench mark that would influence the level of long term interest rates, including those on loans and advances by financial institutions. Increasing the central bank rate drives market interest rates up yet this raises the cost of borrowing and discourage credit expansion, there

by slowing down aggregate demand and vice versa. Lower aggregate demand slows down inflationary pressures seeking to reduce inflation from double digits to low single digits.

Commercial banks being liberalized they choose to make their own percentages of lending rates other than following bank of Uganda central bank rate. Nalyali (2015), an ex-banker, told said that Uganda's economy being liberalized, to the extent that banks choose not to respond to Bank of Uganda's actions but twig to their methods of calculating lending rates basing on the cost of funds, administrative costs among other factors. He added that what Stanbic bank has done could be a marketing elevation, but which could be useful in making the public believe that the bank is submissive with Bank of Uganda's suggestions. But apart from that he said, commercial banks should follow the central bank rate because it is good and sends a signal on where interest rates should go.

Sometimes commercial banks follow the central bank rate indirectly because when it's reduced they also reduce it and when it's high they also hike the lending rates. Opolot (2014), the director for research at Bank of Uganda, was positive about Stanbic's announcement. "I think they have been responding to the central bank rate indirectly and now they will be doing it explicitly," he said. Though they had not formally announced in adverts, most banks could be indirectly responding to the central bank rate because the average commercial bank lending rates have reduced in the period when the central bank rate was being reduced to the current 11.5%.

The efficiency of a commercial bank affects the loan setting. Kaboyo (2014), the managing director at Alpha Capital Partners, was optimistic. "In Uganda the correlation between the policy rate and commercial interest rates has been weak," he said, adding that the revision of the policy rate downwards has not been prompting similar change in commercial bank

lending rates. Consequently, the spreads in Uganda are relatively high in the range of 7% - 13%, he said. He said the primary determinants of interest setting behaviour of any commercial bank are; liquidity, funding structure and market power among others. Furthermore, the degree to which a bank operates in a cost efficient manner affects its loan setting behaviour, which means the less cost proficient a bank is, the higher will be the interest rates to offset its inefficiencies. This means other banks might look through the tight competition which could sway the market in favour of the most cost-efficient banks.

Bantu and Douglas (2014) from the Communications department and personal and business banking respectively, stated that though the new approach intends to align with Bank of Uganda's central bank rate movements, some of the loan facilities are too risky in nature, which is why they were factoring in the liquidity and premium risks. In their opinion, this is a reward for the good customers to get good interest rates and a challenge for the bad borrowers to improve on the way they meet their loan obligations.

Firms are starting to borrow cheaply from abroad to side step high lending rates in the Ugandan markets. Commercial bank lending rates in Uganda are the highest in East Africa leading to lower than projected credit growth and climbing non-performing loan ratios, according to a New Vision survey (2015)

The average shilling commercial bank lending rate in Uganda hit 23% in July, from 22%, and to some extent; rigidities in the Financial Institutions Act are to blame. Kenya's average commercial bank lending rate for the six most dominant banks is at 17% for the country's 43 licensed commercial banks. The normal loaning rates in the country usually average between 12% and 15%. Tanzania's maximum prime rates are just at 21%, many commercial bank lending rates in the country are below this point. Lending rates in Rwanda and Burundi are

safely below the 20% mark. Experts argue that infrastructure and structural issues are partly to blame for the high rates in Uganda. Mugume (2015)

Due to narrow access to electricity around the country, semi-developed road network and the uneven distribution of commercial banks, Ugandans spend about \$4.2b (sh11.4 trillion) annually to access banking, according to the Global Financial Inclusion Indicators 2011. Only 20% of the entire Ugandan population has interfaced with a bank and alternative saving mechanisms hold relatively small shilling amounts per household, effectively handing bankers the ability to keep lending rates high. Sanyu (2015)

Mutebile (2014), the Bank of Uganda governor, recently increased the benchmark Central Bank Rate to 12% to manage inflation prospects and followed with a warning to bankers to lower rates in their banks. Commercial banks make at least 11.5% profit on deposits and the World Bank says the interest spreads are too high. Bankers say this is likely to continue until the financial institutions act is changed to allow for agency banking or until commercial oil production starts, whichever comes faster. Kenya and Rwanda currently allow for agency banking, where shop keepers, super markets, grocery stores and mobile money agents work on behalf of banks to enable individuals to deposit and withdraw their savings.

“There are a lot more current accounts in Kenya, making it cheaper to access deposits for lending. What we need is more people banking to bring lending rates down,” Kituuka (2014) of KCB said. “Agency banking allows people even in the remotest villages to access banking services through their shop keepers. The Financial Institutions Act should be amended and people sensitized about agency banking,” he added. If just 500,000 people save at least sh100 every day with their shopkeeper, there would be an additional sh50m for lending every day. Kituuka notes that a larger banked population will enable the banking sector to move from

premium based pricing as even small levels of interest will be able to deliver larger profit. Alternatively, large sums from the oil sector could provide cheap deposits to sustain commercial bank lending.

Uganda's central bank kept its main lending rate at 11 percent for some time, saying inflation was within its target and the economy was on track to grow 6 percent this fiscal year. The Bank of Uganda cut its benchmark rate to 11 percent in June as Mutebile (2014) voiced concerns that downside risks, from the global and internal economy, meant Uganda would not be able to return to economic growth of around 7 percent achieved in previous years. People doing businesses in Kampala, have closed their shops and have decided to boycott banks to protest against high interest rates. Uganda's central bank raised rates last year when inflation hit more than 20%. Merchants in Kampala say interest rates of up to 27% are crippling their businesses.

The Bank of Uganda increased its base rate last year in response to soaring inflation, prompting banks to increase rates on new and old loans and pushing up the cost of doing business. Mbabazi (2014) the prime minister says the government is looking at ways to help people struggling to repay loans because of the rate hikes, but says striking may aggravate the problem. "I don't think striking will save [traders'] property; I don't think striking will save your business, Mbabazi stated.

But some bankers see an upturn in the banks' fortunes. "Though bad loans were a big problem for everyone last year, the business environment seems to be improving coupled with lower interest rates. This might help reverse some of the damage caused by huge bad loan expenses but the positive impact of this will most likely be felt in this quarter," said Mweheire (2012), the executive director at Stanbic Bank Uganda.

Corfe (2015), said that as far as monetary policy is concerned, low inflation is going to lead to even more inaction from the Bank of England - CEPR now expects the Bank's Monetary Policy Committee to keep the base rate of interest on hold until February 2016. Economists cautioned that a rise may come sooner if the Bank's buoyant outlook for the economy arrived. Delivering the latest Inflation Report, which included the strong possibility of a bout of deflation in the coming months, Carney (2015) said base rate should rise in line with the market's current expectations. If rate rises came in 0.25 per cent increments, that would put the inflection point between a 0.5 per cent and 0.75 per cent base rate in May next year.

Carney (2015) raised the prospect that if deflation became entrenched the Bank could be forced to cut rates and deliver more quantitative easing, but when questioned on the prospect of negative rates in the UK he reiterated that the most likely next move for base rate was up. He added that prices falling in the coming months would boost disposable income and spending and the Bank has upgraded its growth forecast.

Archer (2015), chief economist at IHS Global Insight, said: 'Coming into the Quarterly Inflation Report, our view was that it is touch and go whether the Bank of England first hikes interest rates at the end of 2015 or waits until early 2016. We maintain this view. 'Looking at the consumer price inflation forecasts (and pretty buoyant growth projections) contained in the Quarterly Inflation Report and listening to Governor Mark Carney's comments, it looks like the markets had got ahead of themselves in not expecting any interest rate hike before mid-2016.'

Loans are the main source of revenue for banks, as are customer deposits on which they levy bank charges. When bankers fail to meet targets on these two revenue heads, the stakeholders get very worried. Yet, non-performing loans and other assets (NPAs) and bad debts written



off continued to eat into the banks' profits, thus reducing their profitability. This is the key performance indicator cutting across all commercial bank financial statements seen by The Independent. Carney (2015)

Monetary policy implementers believe the economy will rebound from the 5.8% growth registered in 2012/13 to over 6% in 2013/14 due to the somewhat favourable exchange rate, lower inflation and stable interest rates. But many of the managers of Uganda's 26 commercial banks can be forgiven for being cautiously optimistic. Larmbert (2015)

Isiko (2015), the acting managing director at Bank of Africa, which though is yet to publish its financial results for 2013, said that customers were still reeling from the effects of a difficult 2011 and that the bank was still re-assessing potential credit recipients. He says it is a general stance for all banks and it is affecting productivity.

### **PERFORMANCE OF COMMERCIAL BANK**

The availability of loans is a factor that influences bank profitability. Commercial banks borrow for the purpose of lending at a higher interest. Bank grants various types of loans to the industrial and traders thus most of the banks income is generated from loan production. The margin between the interest rate the bank pays the depositors and interest rate it charges for loans represents the banks profit. Therefore, the higher a bank's loan –to-deposit ratio, the more money it can earn in terms of lending revenue Kinsella (2014)

The deposits of the public like demand deposits, savings deposits and fixed deposits constitute an important item on the liabilities side of the balance sheet. The success of any banking business depends to a large extent upon the degree of confidence it can in still in the minds of the depositors. The bank can never afford to forget the claims of the depositors.

Hence, the bank should always have enough cash to honour the obligations of the depositors, Somashekar, (2009)

Interest rates also determine bank profitability. The funds raised by the bank through various sources are deployed in various assets. These assets yield income in the form of interest and the, higher the interest the greater the profitability. Another driver of income is spread which is the difference between the interest income and the interest expense. Higher spread indicates more efficient financial intermediate and higher net income. Thus, higher spread leads to higher profitability. ( Shah, 2010)

Tumusiime (2012) said he expected private lending to grow adding commercial banks had room to lower their rates further. The regulator held its key interest rate at 12 per cent for the fifth straight month. In April, year-on-year rate of inflation fell to 3.4 per cent from 4 per cent the previous month. Standard Chartered Bank Uganda's non-performing loans and other assets rose by 87 per cent to Ush10.3 billion (\$4 million) in 2012 but its provisions for bad debts fell by 18 per cent to Ush7 billion (\$2.7 million), a sign of positive outlook on the quality of its loan book in the medium term. Its assets increased from Ush1.9 trillion (\$765.7 million) in 2011 to Ush2.5 trillion (\$964.6 million) last year.

Housing Finance Bank Uganda saw its bad loan costs grow by more than 100 per cent in 2012, grossing Ush5.9 billion (\$2.3 million) while its non-performing loans and assets grew by 99 per cent to Ush21.8 billion (\$8.4 million) during the same period. Mortgage loans posed one of the biggest problems in the banking sector last year. Falling incomes from new branches opened in 2010 also depleted some banks' earnings, especially the new players, and this compelled bank headquarters to subsidize certain outlets across the country," said Kaboyo (2012), Managing Director at Alpha Capital Partners, a forex trading and financial consultancy firm.

Whereas the banks posted a rise in profits in 2012 amid tough economic conditions, massive growth in costs incurred on bad loans and weaker performance in new branches threatened to ruin the party, analysts said. A mixed short term outlook has created uncertainty over this year's forecast with analysts projecting a rise in bad loans. A spell of aggressive lending experienced in 2009 and 2010 that was targeted at retail customers apparently backfired, with many small borrowers falling into financial distress in early 2012, analysts and bankers said. "The first quarter of 2013 has been equally challenging but we are counting on reductions in operating costs to enable us guarantee good performance," said Kalan (2012), managing director at Crane Bank Ltd.

According to Kasekende (2013), by the end of the year 2000, commercial bank credit to the private sector was only 6 percent of GDP and banks only lent out 54 percent of their deposit base to the private sector. By the end of 2012, 80 percent of the banks' deposit base had been lent out to the private sector and private sector credit as a share of GDP had risen to 15 percent. In the twelve years since the end of 2000, bank lending to the private sector has risen fivefold in real terms. The first issue of concern which Dr. Louis Kasekende discussed is that of interest rate spreads and margins, which are very high in Uganda. The average net interest margin of the Ugandan banking industry in 2012 was 12.7 percent. This is much higher than the average for sub-Saharan Africa which was 7.5 percent, which is in itself much higher than in most other regions of the world. Net interest margins fell from 14 percent in 2005 to just over 10 percent during 2008–2010. This implies that, with nominal commercial bank lending rates currently averaging nearly 25 percent, borrowers are paying real lending rates which average almost 20 percent.

Managing Director Kasi (2015) said the general profitability of the banking industry has declined despite the stabilization of the economic factors such as inflation, interest rates and

exchange rates mainly because banks are emerging from very hard conditions registered in 2011/12. “Clients who had borrowed then found trouble generating enough cash flows to meet their loan obligations in time, thus the increased non-performing loans and write offs,” he said, adding that demand in the economy is just rebounding thus the low demand for credit in the economy. On the increasing number of NPLs, Kasi said, it is a concern for everybody.

Stanbic Bank, Uganda’s biggest bank by assets, took the heaviest hit, recording a 25% drop in net profits amounting to Shs 101.8 billion down from Shs 130.7 billion in 2012, despite a decline in NPLs to Shs 79.1 billion in 2013 from over Shs 101 billion in 2012 while the bad debts written off also went down to Shs 65.3 billion from Shs 93.4 billion in 2013 and 2012.

That situation has spelt doom for the banking industry, which three years ago was one of the most profitable in the country. Equity Bank’s bad debts written off doubled to Shs 2.9 billion in 2013 from Shs 1.1 billion in 2012, while NPA’s shot to Shs 8 billion compared to Shs 7 billion in 2012. Interest earned on deposits and placements and interest earned on fees and commission were the only source of revenue for the bank. Consequently, the bank’s total revenue dropped by Shs 1.3 billion to Shs 58.2 billion. Centenary Bank’s bad debts written off almost doubled to Shs 7.8 billion from Shs 4.7 billion in 2012. Larmbert (2015).

Commercial banks in Uganda remained resilient in 2011 despite the challenging macroeconomic environment. The sectors profitability improved and banks remained sufficiently capitalised. In 2011, banks after tax earnings were Ushs.488.3 billion, compared to Ushs.268.7 billion in 2010 as a share of total financial income, income from loans and advances rose from 53.7 percent in 2010 to 62 percent in 2011 charges and fees on loans and deposits amounted to 13 percent of total income, although this was down from 14.6 percent

in 2010, growth in earning on government securities continued to show down, rising by 13 percent in 2011 compared to 10.2 percent during 2010. Bank annual supervision report (2011)

According to Nampewo (2005), the lifting the moratorium of 2005 led to opening up of nine new commercial banks bringing total number of banks in Uganda to 25 in 2012. In terms of assets holdings, commercial banks have experience stable growth since the lifting of the moratorium in 2005. During this period, commercial banks total assets rose from a total of shillings 2991 billion in 2003 to shillings 13.5 trillion in 2012, similarly total liabilities grew by the same amount in the same period, and most of the growth was driven by loan advances to customers which increased from Ushs.855 billion in 2003 to Ushs.6515 billion in 2011.

The determinants of profitability of commercial banks focuses on return on assets and on equity and the net interest margin. In this context, usually are analysed impacts of special factors of banks in their performance such as risks, market power, administrative expenses and the cost of the reserve requirement Govori and Fadil (2013).

Brock and Suarez (2000) analysed the determinants of the interest rate margins of the many Latin American countries during the mid-1990s. Their study showed that higher operational costs and the high level of provisions for credit losses influence the higher interest gap, although the size of the impact varies by the country. The required regulatory resources also influence the higher gap in the economy.

Flamin et al. (2009) studied the determinants of profitability of the commercial banks from in countries in sub Saharan Africa, including 389 banks from 41 countries in the region. The study unveiled that besides credit risk, higher returns on assets are associated with the size of the banks, variability of the activities and private ownership further more bank returns resulted to have been affected by the macro economic variables and the level of capital.

Athanaso Glou et al. (2006) applied the dynamic model with the panel data for the study of performance of Greek banks for the period 1985 – 2001. The results showed that the performance of Greek banks depends on internal factors of banks. Capital, credit risks, productivity, cost management and the size of banks from specific factors of industry. The ownership and concentration, and the macroeconomic factors. Expected inflation and production cycle.

The Indian financial land scope is dominated by the banking sector with banking flows accounting for over half of the total financial flows of the economy. Banks play a major role in not just purveying credit to the productive sectors of the economy but also as facilitators of crisis. It has been impacted by the global and domestic economic slow-down over the first two years. The year 2011 – 2012, against the back drop of muted domestic growth, witnessed a slow-down in the overall growth of the banking sector coupled with deterioration in asset quality and lower profitability. The performance of the banking sector 2012 – 2013 too was conditioned by a further slowdown of the domestic economy, although there was some despite from inflationary pressures leading to an environment of lower interest rates. Annon (2013)

According to Cornett andTehranean, (n.d) five types of regulation seek to enhance the performance and value of commercial banks and thus the viability of the commercial banking industry. These include entry regulations, safety and soundness regulations, credit allocation regulations, consumer protection regulations and monetary policy regulations. Entry regulation involves increasing or decreasing the cost of entry in to a financial sector which affects the performance of commercial banks.

Wheelock and Wilson-(n.d) examine issues associated with entry regulations and commercial bank performance. Specifically, this paper quantifies the regulatory, market and financial characteristics that affect the probability of a bank engaging in mergers. The authors find that

the regulatory approval process required for a bank performance and the quantity of a bank management significantly affect expected mergers.

In conclusion commercial banks perform several valuable services to sectors of the economy. The effect of the disruption in the provision of the various services on firms, households and the overall economy when something goes wrong in the commercial banking sector makes a case for the need to monitor performance and market value and to impose regulations may be beneficial to households, firms and the overall economy, they also compose private costs that can affect the performance and market value of commercial banks.

### **REAL INTEREST RATE**

Real interest is nominal interest rate minus the inflation rate. The real interest rate measures how expensive it is in terms of goods to borrow purchasing power. Real interest rates can be illustrated by the Fisher equation  $R=A-I$ , where  $R$  denotes real interest rates,  $A$  denotes nominal interest rates and  $I$  denotes inflation rate. Lending money always carries an element of risk just in case the borrower goes bankrupt before the loan is due. The rate of interest on long-term loans depends upon the willingness of lenders to lend long term compared with the desire of borrowers to borrow for long periods. Financial institutions lending money are so interested in the financial health of those whom they lend. The riskier they believe the loan is, the higher the real interest those lenders will demand to compensate them for risk. (DeLong, 2002).

Howells (1998) therefore defined real interest rates as the rate of interest that lenders would need to compensate them for postponing consumption until some point in the future, given constant prices. Borrowers pay real interest rate as a price in order to be able to consume resources now rather than at some point in the future. Real interest rates have been low by historical standards since 2000 due to a combination of factors including relatively weak

demand for loans and strong savings in newly industrializing countries but currently the interest rates have increased in commercial banks and are now around 24 percent.

Mankiw, 2010 says real interest rate is nominal interest corrected for the effect of inflation. According to him, there are two types of real interest rates, ex-Ante and ex-Post. Ex-ante real interest rate is the rate that the borrower and the lender expect when the loan is made. Ex-post interest rates is the real interest rate that is actually realized. The borrower and lender cannot predict future inflation with certainty. They just have some expectation about the future inflation. The expected real interest rate can vary considerably from year to year. The interest rate on short term is strongly influenced by the monetary policy of central banks while the real interest rates on longer term bonds tend to be more market driven. Real interest rate is used in various economic theories to explain some phenomenon like capital flights, business cycle and economic bubbles.

Gitman (1997) asserts real interest rates are the rate that creates equilibrium between the supply of savings and the demand for investment funds in a perfect world, without inflation, where funds suppliers and demanders have no liquidity preference and all outcomes are certain. He adds by saying that the real interest rates change with changing economic conditions, tastes and preferences. When real interest rates is high, that is demand for credit is high, the money will, all other things being equal, move from consumption to savings while when real interest rate is low, demand will move from savings to investment and consumption. Real interest rates measure the true cost of borrowing and thus determines the quantity of investment.



## **NOMINAL INTEREST RATES AND THE PERFORMANCE OF COMMERCIAL BANKS**

Nominal interest rates are the return to saving and the cost of borrowing without adjustment for inflation. They are the rates you actually see and pay. It can also be defined as the sum of the real interest rate and inflation rates as derived from the Fisher equation.

$I=R+A$  where  $I$  denotes nominal interest rate,  $R$  real interest rate and  $A$  an inflation rate. This equation shows that nominal interest rate can change due to changes in real interest rate or changes in the level of inflation rate. However, (Van Horne, 1995) states that on theoretical level, there are reasons why the nominal interest rate may not conform exactly to changes in inflation. He says that arguments exist to justify the relationship being less than one to one as well as more.

Mundell and Tobin-(n.d), present a theory where changes in the expected rate of inflation raise or lower the nominal rate of interest by less than the expected inflation rate change. In case of an increase in expected inflation, this change is said to be reflected in both an increase in the nominal rate of interest and a decrease in the real rate. He also adds that in the crux of Mundell's contention that the real rate of interest declines under such circumstances is that inflation reduces real money balances. In other words, money assets depreciate in real terms. As a result, real wealth a decrease in expected inflation or decreased deflation, growth and investments reduce. Here the real interest rate rises and as a result, the nominal rate of falls by less than the changes in expected inflation, the response of the nominal rate of interest to the expected inflation is less than to one.

Nominal interest rates is what is normally observed and quoted and represents the actual money paid by the borrower to the lender, expressed as a percentage of the sum borrowed over a stated period of time (Casu, 2006).

Gitman (1997) defined nominal interest rate as the actual rate of interest charged by the supplier of funds and paid by the demander. Nominal interest rates are always reported. The money people hold in their wallets does not earn interest. If instead of holding that money, they used it to buy government bonds or deposit it in a savings account; they would earn nominal interest rate. Therefore nominal interest rates are interests that investors pay to borrow money and the opportunity cost of holding money

(Mankiw, 2010) says nominal interest rates are used to calculate interest due on a loan. The quantity of money demanded depends on the price of holding money. Hence the demand for real money balances depends on both the level of income and on the nominal interest rate. The higher the nominal interest rates, the lower the demand for real money balances. Changes in the price levels are, by definition, the rate of inflation. Inflation in turn affects the nominal interest rate through the Fisher effect. But because the nominal interest rate is the cost of holding money, the nominal interest rate feeds back to affect the demand for money.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

### **RESEARCH METHODOLOGY**

#### **INTRODUCTION**

The researcher used analyses to explain methods that were used to collect and analyse data then present it. It also structured the study duration of the study. These methods were then followed by the researcher when he or she sets off to the field to collect empirical data. It provides a narrative of the methods and techniques that were used for the purpose of this study to help the researcher attain the study mentioned in the earlier chapters. It included the research design, study area, study population, sample size, sampling design, data sources, quality control measurement of variables, data analysis and presentation, ethical issues and study limitations.

#### **RESEARCH DESIGN**

The choice of research design reflects decisions about the priority being given to a range of dimensions of the research process. Research design, is a plan that specifies the sources and types of information relevant to the research.

The research design adopted for this study was the case study design to bring about deeper insights and better understanding of the phenomena as it is very important in testing the hypothesis of the study. The researcher used this design because it was used by Creswell, 2013b; Denzin and Lincoln, 2011b; Mercom, 2009.

The research was conducted by use of largely qualitative because it is analytical and it explained experiences of those involved and some quantitative because it helped the researcher manipulate figures, tables so that they are able to be interpreted

The time dimension is cross sectional because it is for a single period and a snap short study.

## **STUDY POPULATION**

The population of the study included all the employees of Centenary main headquarters from whom the researcher got information. The employees included tellers, accountants, loan officers, credit analysts, managers among others. The number of the study population was 47. The employees were able to provide the researcher with information because they know a lot about the bank and the services offered and how they affect their performance. The unit of analysis was centenary rural development bank.

The unit of inquiry included accountants, managers, tellers, and cashiers among others since this is the target group of the study, these were the most convenient to provide the information that the researcher needs.

## **STUDY AREA**

The study area was centenary rural development bank, the head office located on Plot 44-46 Kampala road Mapeera house, plot 2 Burton street Kampala.

## **SAMPLE SIZE**

Sekaran (2003) observes that a sample size is largely determined by the level of precision and confidence desired in estimating the population parameters as well as the variability of the population itself.

The study used the krejice and Morgan table (1970) to determine the sample of 47. The samples for the respective classes were computed and shown in the table 4.5.1.

### **Table: 4.5.1**

	<b>Population</b>	<b>Sample</b>
Top management	20	19
Lower management	30	28
<b>Total</b>	<b>50</b>	<b>47</b>

Source: krejice and Morgan table (1970:608)

Top management:  $20 \div 50 \times 47 = 19$

Lower management:  $30 \div 50 \times 47 = 28$

### **SAMPLING TECHNIQUES / STRATEGIES / APPROACHES**

This study utilized the stratified sampling technique and used probability sampling. The researcher used the employees of Centenary bank: head office as he or she believes them to be more knowledgeable about the investigation (interest rates and the performance of commercial banks). Convenience sampling strategies were also used as the researcher concentrated on the individuals who can easily be accessed that is, employees of centenary bank: head office.

### **DATA SOURCES**

#### **Primary sources**

The researcher used the staff of centenary as the source through interviews and questionnaires to get firsthand information and these enabled the researcher study more about the problem in the trends before and currently.

### **Secondary sources/data**

The researcher used already existing information provided by other researchers in textbooks, reports, journals, government documents, citations, magazines, newspapers, dissertations and the internet to compile information necessary for the study as these provided enabled the researcher study the trend of the problem and enable consistency.

### **METHODS OF DATA COLLECTION**

The researcher used the following data collection instruments: from the primary and secondary sources to collect data during research;

#### **Primary data sources**

This is data gathered that originated by the researcher for the specific purpose of addressing the problem at hand. It involves the researcher getting firsthand unique information this can be through;

**Interviewing;** this is a conversation in which the researcher tries to get information from the interviewee and records it by him or herself. The method assumes that the respondent has the information and that he or she is willing to give honest answers while the researcher is present. The interviewer (researcher) asks questions and the interviewees (respondents) answers giving their opinions as regards to the study. Therefore the researcher interviewed the employees of Centenary bank: head office face to face and these included the loan officers, the managers and the accounting officers because they have much more knowledge on how the interest rates affect the performance of centenary bank. They also gave clear firsthand information.

**Questionnaires;** This study on interest rates and the performance of commercial banks in Uganda were aided by the use of both the structured and unstructured questionnaire type.

Each respondent received the same set of questions irrespective of their status in the organisation, questions that were phrased in exactly the same way. Questionnaires also helped the researcher by providing that that was amenable to quantification. The accountants, managers, tellers, loan officers, finance officers received the questionnaires because they were the most convenient people to provide the information the researcher needed and they were the people that had the required knowledge on the issue discussed. This method enabled the researcher to get first hand, accurate information or answers to sensitive questions that respondents may not be ready or may not easily answer during interviews. This method favours respondents who are shy.

## **DATA ANALYSIS AND PRESENTATION**

### **Quantitative data**

This is where the researcher mainly tests the goodness of the data collected; the hypothesis developed for the research and gets a feel of the data (Sekaran, 2003).

The researcher evaluated the worth of the collected data, analysed, and assessed the data in quantitative analysis by which he or she made use of the SPSS 16.0 to organise, collate, analyse and present the findings using tables and graphs.

### **Qualitative data**

This is non-numeric. The qualitative research method places emphasis on words and here the researcher categorised responses and tried to see those that gave the same and different responses and categorise each. The qualitative research aided this research report through employing techniques such as focus groups and in depth interviews. The findings were presented in written and table form and the data was recorded, sorted out and compiled.

## **QUALITY CONTROL**

**Reliability:** The researcher used test re-test where data was collected from them and given a short period of time and the researcher went back collected data using the same questions and compared the information given which offered a sense of reliability.

**Validity:** This means that when the questions are asked with the hope that the concept is being answered, there is no certainty that the concept is indeed being measured. The researcher used experts and her supervisor to get the information needed and received comments from them and considered it.

## **MEASUREMENT OF VARIABLES**

This research compared the data from selected financial periods in the organisation and this was the main basis of measuring bank performance. This helped the researcher determine whether there was an improvement or a decline in the levels of bank performance in commercial banks, centenary in particular. The researcher used different authorities to measure his or her variables and these include government authorities, the main bank which is bank of Uganda, microfinance authorities and many others.

**Independent:** the information was used by Delong2002 who says when the loan risk is higher the real rate of interest of those lenders will demand for compensation in case of any risk.

**Dependent:** The information was used by Mugume (2011) in the bank of Uganda annual supervision report who said that the Commercial banks in Uganda remained resilient in 2011 despite the challenging macroeconomic environment. The sectors profitability improved and banks remained adequately capitalised. The increase in the central bank rate intended to curb inflation slow down growth of deposits and credit, and raised concerns about the potential adverse impact of higher interest rates on loan quality.



## **ETHICAL CONSIDERATIONS**

For this research to be carried out amicably, the researcher first asked for permission to carry out a study at the organisation (Centenary bank).

The information given by the respondents was treated with the utmost confidentiality with regard to their privacy and anonymity. Great care was taken in making sure the anonymity of individuals was maintained.

The nature of the study was not in any way misrepresented by the researcher.

The researcher cited and acknowledged all the sources that she used for the study

Irrespective of the nature of data collection, the self-esteem and self-respect of the subject was not violated.

## **STUDY LIMITATIONS**

The limitations of the study can be the characteristics of the research design or methodology that will affect or influence the interpretation or application of the results of the results of the study.

One of the limitations to this study was the aspect of time. There was not enough time as there should have been to carry out a comprehensive study of the variables. Economic constraints to the researcher also hindered the movement to centenary bank very often.

The nature of the data collected process was another limitation. The data that had to be collected using questionnaires which meant that there was no absolute way to be independently verified due to time constraints and the confidentiality of the organisation. In other words, the researcher had to take the respondents responses as the absolute truth

The researcher also faced hostility from some respondents who were not willing to fill the

questionnaire. The researcher gave them an ample time and communicated to them well for them to participate

## **CHAPTER FOUR**

### **PRESENTATION OF RESULTS AND DISCUSSION OF FINDINGS**

#### **Introduction**

The main objective of this study was to determine Interest rates and the Performance of Commercial Banks in Uganda. This chapter therefore presents the research findings of the study and an analysis of the data collected for this research. All statistical tests were performed using SPSS 16.0. A questionnaire was administered to help to assess interest rates on the performance of the organisation.

#### **Back ground information of respondents.**

With a questionnaire as the main research tool to gather data from the respondents, the first section of the questionnaire was intended to gather data on the background information of the respondents. The background information of the respondents was considered necessary because the ability of the respondents to give satisfactory information on the study variables greatly depends on their background. The petitioned data was categorised into; gender, education levels, age and length of service in the organisation.

#### **Gender characteristics of respondents**

The various age groups of the respondents that took part in the case study was sought and that data is presented in the table below:

#### **Table 4.1: Gender characteristics of the respondents.**

Gender	Frequency	percentage
Male	23	51.1
Female	22	48.9
<b>Total</b>	<b>45</b>	<b>100</b>

*Source: primary data 2015*

Table 4.1 above reveals that 51.1% of the respondents were male, 48.9% were female and three Questionnaires were not returned there for undetermined. These percentages could show that there are still low levels of employment of females in centenary bank in Uganda.

#### **Description of age groups of the respondents**

The study acquired particulars about the age groups of the respondents for purposes of understanding their age.

Details of the findings are shown in table 3 below;

**Table 4.2: Age groups of the respondents**

Age Group	Frequency	Percentage
18 – 25	2	4.4
26 – 35	33	73.3
36 – 45	10	22.2
<b>Total</b>	<b>45</b>	<b>100</b>

*Source: primary data 2015*

From the table above, it is vibrant that the majority of the work force at Centenary bank are represented by 4.4% (18– 25), 73.3% (26 -35), and 22.2% (36 -44). Three questionnaires were not returned therefore the ages of those respondents are undetermined. With the above information, it can therefore be determined that the majority of the respondents are in their most fruitful age brackets of their life and are rationally experienced (assuming that an average Ugandan starts work at the age of 23 years).

**Table 4.3: Educational background of the respondents**

Education level	Frequency	percentage
Diploma	3	6.7
Bachelor degree	28	62.2
Post graduate	14	31.1
<b>Total</b>	<b>45</b>	<b>100</b>

*Source: primary data 2015*

In table 4.3 above, it can be revealed that the majority of respondents (62.2%) hold a bachelor's degree while another 31% hold a master's degree, and 6.7% hold a Diploma. This means that the respondents are adequately qualified persons intellectually and were accordingly selected for their respective positions based on their qualifications, among other attributes that were required. Three of the respondent's education level is undetermined because their questionnaires were not returned

#### **Duration on the job of the respondents**

The researcher asked the respondents about the duration of time they had spent in their current jobs to find out their experience in the organisation. It should be noted that a majority of the respondents have served the organisation for 3-5 years. The table below shows this duration:

**Table 4.4: Duration of stay in the organisation**

Duration in organization	Frequency	percentage
3 – 5	29	64.4
above 5	16	35.6
Total	45	100

*Source: primary source 2015*

The table above shows that the majority have served the organisation from 3-5 years with a percentage of 64.4% and for above 5 years with a percentage of 35.6%, then those that have served for 3 years are in a percentage of 6.7% and 2.2% for those that have served for 4 years. Three of the respondents are un determined.

## **INTEREST RATES**

### **Real interest rates**

**Table 4.5. The real rate of interest.**

	N	min	max	mean	std dev.
Are understood by clients	45	2	5	3.71	.815
Affects nominal interest rate	45	2	5	3.89	.532

*Source: primary data 2015*

### **The real rate of interest are understood by the clients**

The results of the study as revealed in the table 4.5 above suggest that the clients understand the real rate of interest at a high level. This is evidently shown by the mean mark from the responses the questions attracted in the case study that the respondents took and was computed by the system. The mean is 3.71. The results also show that some respondents are not in agreement about their clients understanding the real rate of interest as shown by their standard deviation of 0.815. The results of the two respondents whose questionnaires were not returned is unknown. This is supported by Delong (2002) who argues that the rate of interest on long-term loans depends upon the willingness of lenders to lend long term compared with the desire of borrowers to borrow for long periods which shows that some clients do not understand the real rate of interest. Cussen (2015) also argues that those who understand the difference between nominal and real interest rates have therefore taken a major step toward becoming smarter consumers and investors. This means that some clients understand the real rate of interest

### **Real interest rates affect nominal interest rates.**

Based on the details in the table 4.5 above, the mean is 3.89 which implies that most of the respondents have knowledge about the real rate of interest and how it affects nominal rates. This is because they seem to agree with the statements but however the responses appear to vary as shown by the standard deviation of 0.532, this could mean that some respondents have never bothered to acquire knowledge about real rate of interest and how it affects nominal interest rate. This finding is supported by Mankiw (2010) who found out that real interest rate is nominal interest corrected for the effect of inflation. According to him, when a borrower and lender agree on nominal interest rates, they do not know what the inflation rate over the term of the loan will be. It is actually possible for real interest rates to be negative if

the inflation rate exceeds the nominal rate of an investment. Cussen (2015) attributed to the above shows that real rate of interest affects nominal interest rate.

**Nominal interest rates.**

**Table 4.6. Nominal interest rates**

	N	min	max	mean	std dev.
Are understood by clients	45	1	5	3.44	.918
Assets face nominal charges	45	2	5	3.64	.908

*Source: primary data 2015*

**Nominal interest rates are understood by the clients**

From table 4.6 above, there are variances in the responses attained from the respondents as regards the nominal interest rates. A question was asked on whether the nominal interest rates are understood by the clients and the responses varied since some disagreed, others neither agreed nor disagreed and the rest agreed. This averaged to 3.44. This could possibly mean that the clients sometimes do and sometimes do not clearly understand the nominal interest. Some respondents were however in agreement of nominal interest rates being understood by the clients as shown by the mean score of 3.44 with a standard deviation of 0.918. This is supported by Sanga (2014) who noted that few borrowers were borrowing from the bank due to the high rates meaning that the clients do not understand the nominal interest rates. Smart investors know to look beyond the nominal or coupon rate of a bond or loan to see whether it really fits their investment objectives. Cussen (2015) states that some clients understand the nominal interest rates.



### **Most assets are charged with nominal interest rates**

From table 4.6 above, the respondents seem to agree that most assets are charged with nominal interest rates as evidenced by mean scores of 3.64 which is tending towards the maximum score of 5. The responses did vary much as shown by the standard deviations of 0.908. The nominal interest rate is in essence the actual monetary price that borrowers pay to lenders to use their money. Cussen (2015) this brings out the idea that most assets are charged with nominal interest rates.

### **Fixed interest rates**

**Table 4.7 Fixed interest rates.**

	N	min	max	mean	std dev.
The fixed interest do not vary	45	1	5	3.98	.917
Are favourable to clients	45	1	5	3.80	1.057

*Source: primary data 2015*

### **Fixed interest rates do not vary**

The respondents agree that fixed rates do not vary this is reflected in the mean score of 3.98 attained from the responses with standard deviations of 0.917. When a loan is fixed for its entire term, it will be fixed at the then prevailing market interest rate, plus or minus a spread that is unique to the borrower. Lee (2015) Interest rate remains fixed irrespective of market conditions. Annon (2013) .This evidently shows that interest rates do not vary

### **The fixed interest are favourable to the clients**

According to table 4.7 above, the respondents showed that the fixed interest rates are favourable to the clients. The responses received from this study show a mean score of 3.80. There are however variations among the respondents shown by the standard deviation of

1.057 which shows that some of the respondents disagree that fixed interest rates are favourable to the clients. Responding to the delegation of authority and assignment of responsibility as shown by the standard deviation score of 1.057. Generally speaking, if interest rates are relatively low, but are about to increase, then it will be better to lock in your loan at that fixed rate. Depending on the terms of your agreement, your interest rate on the new loan will remain fixed, even if interest rates climb to higher levels. On the other hand, if interest rates are on the decline, then it would be better to have a variable rate loan. Lee (2015). A fixed-rate home loan is excellent for those who are good at budgeting and want a fixed monthly repayment schedule, which is easy to budget and doesn't fluctuate Annon (2013). This hence shows that the fixed interest rate is favourable to the clients.

### **Floating interest rates**

**Table 4.8 Floating interest rates**

	N	min	max	mean	std dev.
They vary with market conditions	45	1	5	3.76	.933
Payments are un even	45	2	5	3.64	.908

*Source: primary data 2015*

### **The floating interest rates varies with market conditions.**

According to table 4.8 above, the respondents do agree with the statement as shown by the mean score of their responses (i.e. 3.76). The respondents however did not all agree on the statement that floating interest rates varies with market conditions, and this is shown by the standard deviation of 0.933. A borrower who is financially secure enough to weather market

volatility in hopes of making lower monthly repayments, choose a floating interest rate. Floating interest rate by name implies that the rate of interest varies with market conditions and floating interest rate can go down or up according to the market conditions. Annon (2013)

**Payments for floating interest rates are even**

The table above shows that most of the respondents were in agreement that payments for floating interest rates are uneven. The mean score was 3.64, with a standard deviation from the mean of 0.908 which shows variations in the statement that some respondents disagreed with it. When it comes to choosing the interest rate, a majority of home loan borrowers go for floating rates and with floating interest rates is the uneven nature of monthly instalments (Anon, 2013).

**PERFORMANCE OF COMMERCIAL BANKS**

**Profits**

**Table 4.9 Profits**

	N	mini	max	mean	std dev
Profits have grown	45	2	5	4.18	.806
Are mainly from loans	45	1	5	4.20	.968

*Source: primary data 2015*

**The profits have increasingly grown.**

From table 4.10 above, the responses are positive, explaining that the statements attracted mean scores of 4.18 out of a possible 5. A large number of responses agreed that the profits

of the organization have increasingly grown. In contrast some disagree and this is shown by the standard deviation of 0.806. This is supported by Ruthoh and Sammy (n.d) who notes that banking industry has experienced a rapid growth in terms of profits, deposits, revenues in the recent past, this trend has triggered a lot of competition in the banking industry. Whereas the banks posted a rise in profits in 2012 amid tough economic conditions, massive growth in costs incurred on bad loans and weaker performance in new branches (Kalan 2012) Mugume (2013) disagrees with the statement saying that profit margins have increased but bad debts written off continued to eat into the banks' profits, thus reducing their profitability. Kasi (2015) also disagrees saying that the general profitability of the banking industry has declined despite the stabilization of the economic factors such as inflation, interest rates and exchange rates mainly because banks are emerging from very hard conditions registered in 2011/12. This evidently states that profits have increased in some banks and reduced in other banks.

### **Profits mainly come from loans.**

As seen in table 4.10 above, the responses show that the respondents do agree that profits are mainly from loans. The responses attracted a mean of 4.20 with the responses deviating from the mean at 0.968. The results show that not all the respondents were knowledgeable in the matter of profits mainly coming from loans. This evidence is supported by Kaboyo (2012) who says that Housing Finance Bank Uganda saw its bad loan costs grow by more than 100 per cent in 2012, grossing Ush5.9 billion (\$2.3 million) while its non-performing loans and assets grew by 99 per cent to Ush21.8 billion (\$8.4 million) during the same period Kagina (2013) disagreed that, banks posted a deficit due to the reduction in demand for new loans and higher default rates on existing ones. Loans are the main source of revenue for banks, as are customer deposits on which they levy bank charges. Carney (2015)

Spaulding (2014) says Loans are the major asset for most banks. They earn more interest than banks have to pay on deposits, and, thus, are a major source of revenue for a bank.

**Turnover**

**Table 4.10. The turnover**

	N	min	max	mean	std dev
Turnover is above average	45	1	5	3.80	1.036
Bank turnover has grown	45	2	5	4.09	.773

*Source: primary data 2015*

**The turnover is above average**

From the table above, most of the respondents seem to agree that the turnover is above average. This is evidently shown by the average score of 3.80 almost to 4 that was attained from the responses with a standard deviation of 1.036 which shows a big range in the disagreements to this statement and still see that the turnover is below average. McIntyre (2015), now a managing director at Transcend International, a bank consulting firm, says internal analysis revealed high turnover which was among the key culprits. This shows that the turnover is above average.

### **The banks turnover has grown over years**

The results reflected in the table above conform to this statement. A questions was asked on whether the banks turnover has grown over years and the respondents were in agreement to the statement that sought their opinions, and high scores were awarded with the mean score of 4.11. The responses also showed little distinction between the attained scores and the average score as shown by the standard deviation was 0.714.this is brought out by Reimink (2013) who says that banks pay higher salaries, but there is more turnover and that employees appear to be more comfortable with their job prospects as turnover has returned to pre-recession levels. This shows growth in turnover over years.

### **The number of customers**

**Table 4.11 The Number of Customers**

	N	min	max	mean	std dev
Many customers	45	3	5	4.42	.621
Customers have grown	45	1	5	4.40	.751
Is above 1,000,000	45	3	5	4.04	.751

*Source: primary source 2015*

### **There are very many customers compared to other banks**

The results shown in the table above show that the respondents are in agreement with the customers being many compared to other banks. Most of the respondents strongly agreed and awarded high scores which are reflected in the average scores of 4.44 while others simply had no idea, which explains the standard deviation of 0.586 This difference in answers can be attributed to the fact that some of the respondents were relatively new in the organisation and did not have a full grasp on the number of customers. This is brought out by Ruthoh and Sammy (n.d) that the number of banks in Migori Township have witnessed tremendous growth in the past few years with growth in customers ranging between 5,000 -10,000 which represent percentage growth of between 50%-100%. Today Centenary is Commercial Bank in Uganda serving over 1.3 million customers.in addition centenary bank was voted the best Ugandan bank at the people's choice quality awards (Centenary annual report, 2013)

### **Our customers have increasingly grown over years**

Most of the respondents seem to agree that customers have increasingly grown over years. The scores attained from this study averaged 4.40 with a standard deviation or 0.751. This shows that the responses did not vary from one another hence justifying the general agreement of the respondents. According to Kasi (2015) he says that the number of customers has grown to 1240,077 hence this shows that customers have grown over years.

### **The number of customers is above 1,000,000**

The table 14 above shows responses on yet another component of performance of commercial banks. From the results above, the respondents seem to agree on the number of customers being above 1,000,000. These attracted average scores of 4.09. The responses did vary as such as shown by the standard deviation of 0.733 who did not have knowledge of the

number of customers they had. Peninnah (2013) secretary centenary bank argues that the Bank continued to pursue its expansion strategy and closed the year with 1,240,077 customers representing a decline of 4.6% from 2012.

### **The number of active accounts**

**Table 4.12 The number of active accounts**

	N	min	max	mean	std dev.
Very many active accounts	45	3	5	4.20	.726
Active accounts have grown	45	3	5	4.18	.684
Active accounts are above average	45	3	5	4.38	.535

Source: primary data 2015

#### **1.1.1 There are very many active accounts**

The respondents seem to agree that the organisation has many active accounts and they awarded this an average score of 4.20 which is a bit close to the overall mark of 5. The responses did not vary as such since the standard deviation was calculated at 0.726 who disagree with the statement. This is supported by the centenary annual report (2013) that says that a decline arose from closure of dormant accounts and transfer of unclaimed balances to Bank of Uganda. The report also says that the increased delivery channels, customer numbers and increased deposit mobilization efforts led to an increase in customer deposits by 18.0% to Shs 965.9 billion from Shs 818.5 billion in 2012.



### **The number of active accounts has grown**

The table above shows that the respondents from the organisation agree on the organisation's active accounts. The table above shows the responses attained mean scores of 4.18 with a standard deviation of 0.684. Mugume (n.d) argues that total bank deposits have increased almost tenfold since the late 1980s, but they have not been translated into more affordable credit for private investment. Centenary annual report says that the increased deposit mobilization efforts led to an increase in customer deposits by 18.0% to Shs 965.9 billion from Shs 818.5 billion in 2012.

### **The number of active accounts is above average**

From the table above, the respondents agree on the number of active accounts being above average. They showed this in their responses that averaged 4.38. The responses however varied by a figure of 0.535 showing a high standard deviation. This is argued out by the centenary bank annual report (2013) which says that the increased delivery channels, customer numbers and increased deposit mobilization efforts led to an increase in customer deposits by 18.0% to Shs 965.9 billion from Shs 818.5 billion in 2012. This therefore confirms that the number of active accounts is above average. In one month, we have already opened 30,000 mobile accounts. We plan to hit 200,000 by the end of the year. Kasi (2015) this hence shows that active accounts are above average.

## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.0 Introduction**

The main objective of this study was to assess the effect of interest rates and the performance of commercial in Uganda. The study was limited to one commercial bank in Uganda, namely Centenary bank Uganda that is among the top commercial banks in Uganda. Chapter five presents the conclusions from the data analysis as well as recommendations and implications of this research study.

#### **5.1 Summary of findings**

This part presents the summarized results and interpretation (findings) based on the study objectives as established at the beginning of the study as shown below;

##### **5.1.1 Real interest rates on the performance of commercial banks**

The research revealed that the clients of the organization understand the real rate of interest, this is because it is fairly simple, real rates promote economic growth, banks pay customers better rates when the real interest rates are high, they are given loans at low rates and also pay low rates for other services when inflation is low however other clients do not understand the real rate of interest because the real rate of interest is more complex, it goes high as inflation factors in and also the cost of borrowing is high but those that have looked at factors that influence the real rate of interest real interest have taken a major step toward becoming smarter consumers and investors.

##### **Nominal interest rates affect performance of commercial banks**

Under this objective of Nominal interest rate it was revealed that nominal interest rates are understood by clients because are cheap and increase saving and the profit margin of banks. The management of the organization is well versed on nominal interest rates and the study

revealed that assets are charged with nominal interest rates like loans, cash, property and equipment and securities. This is because these assets like loans that banks lend out to clients are assets of the bank which clients pay back with nominal interest rates to increase their income.

### **Conclusion**

Basing on the conceptual framework, the dimensions of Interest rates (real rate of interest, nominal interest rate) were linked to the dimensions of performance of commercial banks (profits, turnover, number of customers and number of active accounts) in this study. Therefore to conclude on the appropriateness of the conceptual framework in assessing real interest rates and nominal interest rates to the performance of commercial banks, the slightly modified approach used in this study seems appropriate. The banks should therefore train their employees on the real interest rates and nominal interest rates.

This means that the real interest rates and nominal interest rates are relied upon to make conclusions about the performance of commercial banks as shown by their relationship. Taking all factors into account nominal interest rates and real interest rates, regulated saving deposit rate, profits, operating efficiency, turnover, and liquidity risk, provision for loan losses, market power and gross domestic growth rate lead to performance of commercial banks. The government should therefore regulate the nominal and real interest rates.

## **Recommendations**

Based on the finalized study, the main recommendations to Centenary bank in Uganda and the other commercial banks in Uganda is that they should resolve of elimination or reduction of factors that bring about inflation that rises their nominal and real interest rates. Banks should also fight hard to reduce their interest charges on their customers and also to follow the central bank rate because customers are running to micro institutions for loans which give them their main source of income.

The central bank should put in place measures of observing nominal interest rates and real interest rates related measures such as regulated saving deposit rate, operating efficiency and liquidity risk, provision for loans losses, market power and gross domestic growth rate in order to boost the performance of commercial banks in Uganda.

## **Suggestions for further research**

There are some areas of research that could possibly be carried out considering this study has not extensively covered everything on interest rates and the performance of commercial banks. The following areas can also be looked at for further research:

1. The effectiveness of inflation on interest rate and the performance of banks since inflation is considered one of the main threats of high levels of interest rates.
2. The role of the central bank rates on commercial bank performance.
3. The role of electronic banking in commercial banks.

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## APPENDICES

### APPENDIX I

### QUESTIONNAIRE

Dear Respondent,

I am Nansubuga Jane a student of Uganda Martyrs University. The purpose of this questionnaire is to help me carry out a study to enable me write a dissertation in partial fulfilment of the requirement of the award of the degree of Bachelors of Business Administration and Management. The topic of the study is “interest rates and the performance of commercial banks. The information you will provide will be solely used for academic purpose, and will be treated with the utmost confidentiality. Your responses are kindly sought and needed to these questions.

Thank you so much for cooperation.

#### SECTION: A. BACKGROUND INFORMATION.

Please answer by ticking the most appropriate answer.

1. Gender:

Male

Female

2. In what age bracket do you fall?

18-25  26-35  36-44  45-55  above 56

3. What is the highest level of education you have achieved?

Certificate  Diploma  Bachelor's Degree  Post graduate  others

4. For how many years have you worked in this business?

3-5 years

Above 5 years

## SECTION B

Please indicate the extent of your agreement with the following statements by ticking the appropriate box where:

Guide to ranking: 1=Strongly disagree

2=Disagree

3=Neither agree nor Disagree

4=Agree

5=strongly agree

<b>Interest rates</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Our real rate of interest is understood by the clients					
The real rate of interest affects nominal interest rate					
The nominal interest rate is understood by our clients?					
Most assets are charged with nominal interest rate?					
The fixed interest rates do not vary?					
The fixed interest rates are favourable to our clients?					
Our floating interest rate varies with market conditions?					
Payments for floating interest rates are un even?					

## SECTION C

<b>Performance of commercial banks</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Our profits have increasingly grown?					
Our profits are mainly come from loans?					
Our turnover is above average?					
The banks turnover has grown over years?					
We have very many customers compared to other banks?					
Our customers have increasingly grown over years?					
The number of customers is above 1,000,000					
We have very many active accounts?					
The number of active accounts has grown?					
The number of active accounts is above average?					

**APPENDIX II**

**INTERVIEW GUIDE.**

Question one. Interest Rates.

a) Please highlight the different interest rates from bank charges on its clients.

.....  
.....

b) Are there any challenges your bank faces in establishing the rates of interest?

.....

c) What are the remedies if any for the challenges in (b) above?

.....

Question two. Performance of commercial banks

(a) What do you rate the performance of your commercial bank?

.....

(b) Does your bank make profits? If so, is it sufficient?

.....

(c) Where do you see your bank in the next two years in terms of:

(i) Number of customers?

.....

(ii) Number of active accounts?

.....

**APPENDIX III: KREJICE AND MORGAN TABLES**

**Table for determining sample size from a given population**

N	S	N	S	N	S	N	S	N	S
10	10	100	80	280	162	800	260	2800	338
15	14	110	86	290	165	850	265	3000	341
20	19	120	92	300	169	900	269	3500	246
25	24	130	97	320	175	950	274	4000	351
30	28	140	103	340	181	1000	278	4500	351
35	32	150	108	360	186	1100	285	5000	357
40	36	160	113	380	181	1200	291	6000	361
45	40	180	118	400	196	1300	297	7000	364
50	44	190	123	420	201	1400	302	8000	367
55	48	200	127	440	205	1500	306	9000	368
60	52	210	132	460	210	1600	310	10000	373
65	56	220	136	480	214	1700	313	15000	375
70	59	230	140	500	217	1800	317	20000	377
75	63	240	144	550	225	1900	320	30000	379
80	66	250	148	600	234	2000	322	40000	380
85	70	260	152	650	242	2200	327	50000	381
90	73	270	155	700	248	2400	331	75000	382
95	76	270	159	750	256	2600	335	100000	384

Note: “N” is population size

“S” is sample size.

Krejcie, Robert V., Morgan, Daryle W., “Determining Sample Size for Research Activities”,  
Educational and Psychological Measurement, 1970.







making a difference

Office of the Dean  
Faculty of Business Administration and Management

Your ref.:

Our ref.:

Nkozi, 10<sup>th</sup> December, 2014

**To Whom it may Concern**

Dear Sir/Madam,

**Re: Assistance for Research:**

Greetings and best wishes from Uganda Martyrs University.

This is to introduce to you NANSUBUGA JANE who is a student of Uganda Martyrs University. As part of the requirements for the award of the Degree of Bachelor of Business Administration and Management of the University, the student is required to submit a dissertation which involves a field research on a selected case study such as a firm, governmental or non governmental organization, financial or other institutions.

The purpose of this letter is to request you permit and facilitate the student in this survey. Your support will be greatly appreciated.

Thank you in advance.

Yours Sincerely,

Moses Kibrai  
Dean

